1995

Comment letters to proposed statement of position: Accounting by participating Mortgage loan borrowers;

American Institute of Certified Public Accountants. Accounting Standards Board

INSTITUTE of
MANAGEMENT
ACCOUNTANTS
CERTIFIED MANAGEMENT ACCOUNTANT PROGRAM

September 19, 1995

Mr. Richard Stuart, Technical Manager
Accounting Standards Division
File 4210.PM
AMERICAN INSTITUTE OF CPAS
1211 Avenue of the Americas
New York, NY 10036-8775

RE: Proposed Statement of Position
Accounting by Participating Mortgage
Loan Borrowers

Dear Mr. Stuart:

At its meeting on September 7, 1995, members of IMA's Financial Reporting Committee reviewed the referenced proposed SOP and unanimously agreed to support its adoption as a Statement of Position.

Sincerely,

Hal Rogero/lg

L. Hal Rogero, Jr.
Chairman,
Financial Reporting Committee

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Exposure Draft

Proposed Statement of Position
Accounting By Participating Mortgage Loan Borrowers

Dated: July 5, 1995
Comment Date: October 5, 1995
No.: 800092

To: Richard Stuart, Technical Manager
Accounting Standards Division, File 4210.PM AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Response prepared by: Accounting and Auditing Standards Committee - Society of Louisiana CPAs

Response submitted by: Keith Besson, Member

Comments:

Several members indicated the exposure draft was good guidance. One member stated the exposure draft offered a fairly practical approach to the valuation of the potential liability and amortization of related cost.

One committee member, however, noted the example included in the exposure draft was labeled "Participation in operations and appreciation," but only addressed appreciation in the property. The member questioned whether there should be an example of participation in operations. In addition, the member also indicated the example should also include the footnote disclosures required for each year.

After his initial reading, another committee member questioned the application of paragraph 13, which was not clarified until studying the example in Appendix A. The member recommended the inclusion of a reference for the example which might make for easier reading. This committee member also suggested the loan agreement, as shown in the example, which involved a $10 million loan with a 40 percent participation, is highly unusual for his area of practice - Southwest Louisiana. The member suggested a de minimus amount for which loans under a certain dollar amount (i.e. $1 million) and participation interest (i.e. 25 percent) would be exempt from the provisions of the statement. The member indicated the property in the example in Appendix A is appraised each year, a cost which would be onerous on smaller companies to be in compliance with GAAP.

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September 29, 1995

Mr. Richard Stuart
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Comments on the Exposure Draft of
the Proposed Statement of Position,
Accounting by Participating
Mortgage Loan Borrowers

Dear Mr. Stuart:

We are pleased to submit our comments on the exposure draft (ED) of the proposed Statement of Position (SOP), Accounting by Participating Mortgage Loan Borrowers, which was issued by the American Institute of Certified Public Accountants in July 1995.

We support the proposed SOP and believe it represents an improvement because it standardizes the borrower's accounting for a participating mortgage loan by requiring the measurement and reporting of a participation liability at the end of each reporting period.

Although we support the methodology in the ED, our preference for the borrower's accounting for the lender participation in the appreciation of the property is the "APB Opinion No. 21" method discussed in paragraphs 27 and 28 of the ED. We believe this accounting treatment better reflects the substance and economics of the transaction. The payment of the participation liability is in subtance additional financing costs that under the "APB Opinion No. 21" method would be amortized from the inception of the loan in a manner that results in a constant rate of interest over the life of the loan. In contrast, the methodology in the proposed SOP calls for a cumulative interest adjustment to be recorded subsequent to the inception of the loan and thereafter amortization that results in a constant rate of interest. Thus, under the proposed SOP, the rate of interest in the years prior to the cumulative adjustment would be different from the rate subsequent to the cumulative adjustment. Additionally, we believe that the "APB Opinion No. 21" method correlates with the precepts of the Financial Accounting Standards Board's overall financial components paradigm (i.e., a compound instrument representing an unconditional payable (the mortgage loan) with a conditional payable for the residual or other cash flows from the pledged assets (the participation right)).

Our detailed comments on the ED, organized by reference to the specific paragraph, are enumerated below:

- Paragraph 11: This paragraph does not specifically address the recording of a participation liability. The paragraph should be revised to indicate that the borrower should recognize a participation liability in the period that the borrower becomes obligated for the lender's participation in the results of the operations of the real estate project, and that a corresponding charge should be made to interest expense.

- Paragraph 17: The date in the second sentence should be changed to June 15, 1996. As currently written, an entity with a fiscal year beginning after December 15, 1995, but prior to June 15, 1996, could elect to adopt the proposed SOP early, implement it in an interim period other than its first interim period, and not be required to restate its previously issued interim financial statements for that year. For example, an entity with a fiscal year beginning on April 1, 1996 could elect to adopt the proposed SOP during its quarter ended September 30, 1996 and not be required to restate its previously issued interim financial statements for the quarter ended June 30, 1996.

- Appendix A: Our recalculation of the example yielded results that differed from those presented. Attached to this letter is a copy of Appendix A marked to reflect the differences we noted. In addition, we have also indicated some minor typing changes on the copy.

* * * * *

We appreciate the opportunity to express our views. If you have any questions regarding our comments, please contact James F. Harrington (212-536-2706) or Frederick J. Elmy (212-536-1874).

Very truly yours,

Coopers & Lybrand L.L.P.

EXAMPLE

Participation in operations and appreciation

Assume that Borrower Co. has purchased a property for $10 million. Borrower Co. has paid $1 million cash and entered into a participation mortgage loan agreement with Lender Co. in the amount of $9 million.

The loan agreement has the following terms:

- Fifteen-year term
- Interest-only periodic payments, principal to be repaid at end of term
- 5 percent interest rate
- 40 percent participation in appreciation above $10 million, payable at maturity (or earlier if the asset is sold or the loan is refinanced)

Other assumptions are as follows

- The property is appraised at the following values at the end of each of the next five years:

19X1	$11,000,000
19X2	$12,000,000
19X3	$11,500,000
19X4	$10,500,000
19X5	$11,000,000

- The cash outflows for interest payments in each of the next five years are $450,000 per year.

•

Based on the preceding assumptions, the following table summarizes the activity related to operations and appreciation for the years 19X1 to 19X5:

<u>TABLE 1</u>

	Year	19X1	19X2	19X3	19X4	19X5
A	Participation in Appreciation	$400,000	$800,000	$600,000	$200,000	$400,000
B	Int. Exp. Fixed	$450,000	$450,000	$450,000	$450,000	$450,000
C	Int. Exp. Part. in Appreciation	$ 18,256	$ 55,63[illegible]	$ 12,050	($46,235)	$ 61,582

2

Calculations are as follows:

<u>A: Participation in Appreciation</u>
(Appraised property value at year end — acquisition cost of $10 million) X 40 percent participation percentage.

B: Interest Expense Fixed
Amount of loan ($9 million) multiplied by stated interest rate (5 percent)

C: Interest Expense Participation in Appreciation
See calculation below. Interest expense as calculated in following tables less $450,000 per year fixed interest.

The calculation of the interest expense - participation in appreciation is shown below:

Year 1 (19X1) — Effective interest rate is 5.2 percent (Note: For purposes of this example, the effective interest rates have been rounded). The effective rate is determined based upon an assumed principal due at the end of fifteen years of $9,400,000 ($9,000,000 loan amount plus 40 percent of $1,000,000 appreciation in year 1).

	Interest Expense (Loan Bal. X 5.2 percent)	Payment	Loan Balance
			$9,000,000
19X1	$468,256	$450,000	$9,018,256
19X2	$469,206	$450,000	$9,037,462
19X3	$470,205	$450,000	$9,057,667
19X4	$471,256	$450,000	$9,078,923
19X5	$472,362	$450,000	$9,101,285

Year 2 (19X2) - Effective interest rate is 5.4 percent

	Interest Expense (Loan Bal. X 5.4 percent)	Payment	Loan Balance
			$9,000,000
19X1	$485,973	$450,000	$9,035,973
19X2	$487,915	$450,000	$9,073,888
19X3	$489,962	$450,000	$9,113,850
19X4	$492,120	$450,000	$9,155,970
19X5	$494,394	$450,000	$9,200,364

At the end of 19X2, the borrower reassesses the fair value of the property. At this time, the participation liability is determined to be $800,000 ($2,000,000 appreciation to date multiplied by the 40 percent participation rate). As discussed in paragraph 13 of this proposed SOP, the liability is adjusted to the amount that it would have been had the new effective rate (5.4 percent) been in effect at the origination of the loan. At the end of 19X2, the loan balance would have been $9,073,888 had the 5.4 percent effective rate been used since inception (see 19X2 loan balance column in the second table). Prior to any 19X2 entries, the loan balance is $9,018,256 (see 19X1 loan balance column in the first table). The interest expense adjustment, therefore, is $55,632 ($9,073,888 less X $9,018,256). Interest expense — participation in Appreciation for the remaining years is calculated in similar fashion.

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The entries to record the activity would be as follows:

At the inception of loan/purchase of property

Land	$4,000,000	
Building	6,000,000	
Cash		1,000,000
Mortgage Loan Payable		9,000,000

To record purchase of property and related incurrence of debt.

At the end of 19X1

Loan discount—Part. Liab.(A)	$ 400,000	
Interest Expense (B)	468,256	
indent Loan discount—Part. Liab.(C)		18,256
Part. Liab.—Appreciation (A)		400,000
Interest Payable(D)		450,000

To record the participation liability related to lender's participation in the increase in the market value of the mortgaged real estate project. To record related debt discount and interest expense on the debt.

(A) Item A in Table 1
(B) Sum of items B and C in Table 1
(C) Item C in Table 1
(D) Item B in Table 1

At the end of 19X2

Loan discount—Part. Liab.(A)	$ 400,000	
Interest Expense(B)	505,632	
Part. Liab.—Appreciation (A)		400,000
Interest Payable(D)		450,000
Loan discount—Part. Liab. (C)		55,632

To record adjustment ~~to~~ participation liability related to lender's participation in the increase ~~in~~ the market value of the project. To record interest expense and liability related to lender's participation in the operations of the project.

(A) Cumulative participation from Item A in Table 1 of $800,000, minus opening balance of $400,000.
(B) Sum of Items B and C in Table 1
(C) Item C in Table 1
(D) Item B in Table 1

The journal entries for the next three years reflect the change in estimate of the participation liability and the resulting recalculation of the debt discount based on the revised effective rate.

At the end of 19X3

Interest Expense	$462,050	
Part. Liab.—Appreciation	200,000	
Interest Payable		450,000
Loan discount—Part. Liab.		200,000
Loan discount—Part. Liab.		12,050

At the end of 19X4

Interest Expense	$403,765	
Part. Liab.—Appreciation	400,000	
Loan discount—Part. Liab.	46,235	
Interest Payable		450,000
Loan discount—Part. Liab.		400,000

At the end of 19X5

Interest Expense	$511,582	
Loan discount—Part. Liab.	200,000	
Part. Liab.—Appreciation		200,000
Interest Payable		450,000
Loan discount—Part. Liab.		61,582

The balances of the relevant balance sheet accounts at the inception of the loan and at year-end dates are as follows (Note: The Net Liability balance consists of (1) the $9 million loan balance, plus (2) the participation in the appreciation, minus (3) the discount):

	1/1/x1	12/31/x1	12/31/x2	12/31/x3	12/31/x4	12/31/x5
Loan	$9,000,000	$9,000,000	$9,000,000	$9,000,000	$9,000,000	$9,000,000
Part. Liab. for Appr.	0	400,000	800,000	600,000	200,000	400,000
Discount	0	(381,744)	(726,112)	(514,062)	(160,297)	(298,715)
Net Liability	$9,000,000	$9,018,256	$9,073,888	$9,085,938	$9,039,703	$9,101,285

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October 3, 1995

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Proposed Statement of Position, "Accounting by Participating Mortgage Loan Borrowers"

Dear Mr. Stuart:

We support the overall objectives of the proposed Statement of Position (SOP), *Accounting by Participating Mortgage Loan Borrowers*, and recommend that it be issued. We believe that the SOP would provide useful guidance related to a borrower's accounting for a participating mortgage loan. In addition, we have the following points for consideration:

Interest Costs -

Footnote 1 to paragraph 10 provides that interest relating to appreciation on a participating mortgage agreement is subject to capitalization pursuant to FASB Statement 34, *Capitalization of Interest Costs*. Accordingly, there may be situations where interest costs resulting from a lender's participation in market value appreciation would be capitalized and then, subsequent to construction, the appreciation on the participating mortgage reverses. We recommend that the footnote in the SOP address whether in such circumstances any amounts previously capitalized in accordance with Statement 34 should be adjusted. For practical reasons, we believe such amounts should not be adjusted.

Effective Date and Transition -

It is our understanding based on discussions with the staff of the AICPA that paragraph 18 is intended to provide computational guidance on the interest rate to use in calculating the cumulative effect of adoption when a participating mortgage loan has a variable interest rate. Paragraph 18 should be revised to clearly indicate that it pertains to those circumstances where the loan has a variable interest rate. We also believe that paragraph 18 should be expanded to clarify that the new effective yield, based on the initial interest rate in effect at the inception of the participating mortgage loan plus the expected participation liability as of the date the SOP is adopted, should be used in calculating the cumulative effect.

In addition, the December 15, 1995 transition date referred to in paragraph 17 should be revised to conform to the June 15, 1996 effective date referred to in paragraph 16.

We appreciate the opportunity to present our views and would be pleased to discuss our letter with AcSEC or its staff at your convenience.

Very truly yours,

Ernst + Young LLP

NATIONAL ASSOCIATION OF REAL ESTATE COMPANIES

NAREC

October 5, 1995

Mr. Richard Stuart, Technical Manager
Accounting Standards Division, File 4210.PH
American Institute of Certified Public Accountants
1211 Avenue of the Americas
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SUBJECT: **"Accounting by Participating Mortgage Loan Borrowers"**

Dear Mr. Stuart:

The National Association of Real Estate Companies (the "Association") represents almost 100 major entities which develop, own and/or operate real estate. The major focus of the Association is the broad range of financial management aspects of the real estate business. Since 1978 the Association has been continually involved in the accounting standard setting processes of the FASB and the AICPA. This letter and the attachment present the Association's views with respect to the exposure draft, "Accounting by Participating Mortgage Loan Borrowers". We have copied the SEC's Chief Accountant on this response because we understand that the SEC staff exerted direct influence on the proposed standard.

A number of members of the Association have been directly involved in the considerations of the borrower's accounting for participating mortgages. These considerations have taken place over the past 17 years. Originally, the subject was referred to as "accounting for shared appreciation mortgages." In the 1980's the project was labeled "accounting for innovative financing arrangements." And, currently, the subject is referred to as "accounting by participating mortgage loan borrowers." Volumes of position papers, schedules and financial models supporting the industry's (and the AICPA Real Estate Accounting Committee's) views on this matter have been submitted to AcSEC over the past 17 years. These reviews and the bases for them are summarized in the attached appendix. Our positions have not been accepted -- to the point of AcSEC assuming direct responsibility for this project -- and this letter is, therefore, a final attempt to emphasize preparers' and users' views on this subject.

The single most significant reason for the protracted debates over this subject has been the strong position of the real estate industry that the "simple" solution of estimating the lender's share of property appreciation and accruing this amount as a liability and an expense results in misleading financial reporting. The proposed standard creates significant liabilities, but does not permit the recognition of the underlying asset appreciation which creates the liabilities and which will be utilized to extinguish them.

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Consider the accumulated liability created by the proposed accounting. We project that these liabilities will grow to hundreds of millions of dollars for the real estate industry. We question the relevance of these liabilities to users of our financial statements who need to understand the financial strength and financial flexibility of a real estate entity. Virtually all of these potential obligations will be satisfied by utilizing the underlying property appreciation. The property will either be sold and the realized value shared with the lender or the property will be refinanced based on its value in order to liquidate the participation obligation.

Consider also the expense charges resulting from the proposed standard. The cumulative charges to expense will result in significant cumulative decreases in shareholders' equity. To significantly diminish shareholders' equity and net earnings for a lender's share of property appreciation without recognizing the underlying and offsetting property appreciation is clearly inappropriate for the purpose of reporting (and understanding) shareholders' real economic position with respect to a lender's participation in property appreciation.

To summarize the industry's fundamental position: it is not so much that we oppose reporting a lender's share of property appreciation, it is that reporting it without recognizing the underlying and directly offsetting source of this potential obligation is misleading.

In addition to producing misleading financial statements, this standard will almost surely eliminate a source of capital that is particularly important to start up situations. Participating mortgages have been especially important to smaller and newer companies. An important vehicle for financing real estate projects will no longer be a viable alternative because of the negative accounting effects. Most real estate entities potentially affected by the proposed standard are evaluating alternative financing structures to lenders sharing in the appreciation of their properties. Except for the possibility of entering into joint venture arrangements with lenders, no alternatives having the same economic advantages have been developed.

As indicated above, real estate industry representatives and many representatives of the major accounting firms who have served on the AICPA's Real Estate Accounting Committee have suggested accounting alternatives which would accrue the liability without the inappropriate impacts on earnings and shareholders' equity. The principal alternatives are detailed in the attached appendix. In a recent speech, a member of AcSEC asked a group of real estate financial executives to be constructive in their responses to the proposed standard. Those who have participated in debates over this subject for the past many years would say that the industry has been tenaciously constructive.

We respectfully request that AcSEC seriously consider the significant, inappropriate impacts of this proposal. Until the profession can develop an appropriate standard for the accounting by participating mortgage loan borrowers -- one that fairly reflects the substance of the transactions -- we strongly urge that AcSEC require only the disclosure of lenders' shares of property appreciation in the notes to financial statements.

We are prepared to discuss the Association's position on this matter further.

Very truly yours.

George L. Yungmann,
Director

Robert A. Wilkins
Chairman, Financial Accounting
Standards Committee

attachment

cc: Michael H. Sutton
Chief Accountant
Securities and Exchange Commission

501777

APPENDIX

The Association is opposed to the accounting being proposed in the SOP for the lender's participation in the increases in the market value of the mortgaged real estate project as discussed in paragraphs 12 - 14 and 26 - 32. The quality of the earnings is negatively and unnecessarily impacted by applying the methodology in the SOP and the proposed methodology is exceedingly complex to understand and apply and administratively burdensome. The counter intuitive result of applying this methodology is that as the property increases in value, operating results and "comprehensive income" get worse and decreases in property value produce improved operating results and "comprehensive income".

At the most fundamental level, the obligation to be recorded for the lender's participation in residual value of the property is created as a direct result of an increase in value of the real estate itself. The most troubling aspect of the proposed accounting is that the determination of the property's value is considered reliable enough to cause the borrower to recognize and measure a "potential obligation" and a charge to operations in accordance with SFAS No. 5. However, the increase in property value cannot be recognized in the financial statements until realized. We believe it is fundamentally wrong and misleading to the users of real estate company financial statements to require the recording of (1) significant liabilities without recognizing the underlying asset appreciation which will be utilized to extinguish the liability and (2) cumulative charges to expense which will significantly reduce shareholders' equity until such time as the asset appreciation which gave rise to the charges is recognized upon sale of the assets. The proposed accounting is clearly inappropriate for the purpose of reporting the shareholders' real economic position with respect to a lender's participation in property appreciation.

Not being able to recognize the asset appreciation while having to recognize the obligation seems inconsistent with the accounting concept proposed for potential recoveries discussed in EITF Issue 93-5, paragraph B.38, in the Proposed SOP on Environmental Remediation Liabilities and in SAB 92, where it states that "an asset relating to the recovery should be recognized only when realization of the claim for recovery is deemed probable". Unless recording asset appreciation is held to a higher standard than that for recording obligations, in the case of participating mortgages the test to recognize the appreciation, as required above, would be met.

Additionally, we believe these financing vehicles possess characteristics more closely resembling an equity ownership interest in the residual value of the assets typically collateralized by a non-recourse hybrid financial instrument. The face rates of these types of instruments are less than a typical loan on a property. The lender is taking on significantly more risk by investing in a property and providing non-recoursed financing and a higher loan-to-value ratio than on a typical loan. The lender is being compensated through significant participation in operations and residual value which results in the lender deriving a significant portion of the benefits of ownership of the property. Except for guarantees, the borrower's downside risk is limited by the terms of the mortgage instrument. The borrower is essentially a minority interest partner with an incentive management contract. The payment to the lender at prepayment or maturity of the instrument represents the buyout of the lender's equity interest in the residual value of the asset and should therefore be debited to property.

We believe current and proposed GAAP provide several examples which support our position of charging the participation payment to property. For example, under certain conditions, lenders treat participating mortgages as direct investments or investments in joint ventures. If a review of the loan-to-appraised value ratio, the level of lender participation in management, operations and/or residual value and the level of downside risk the borrower has with respect to property operations, among other rights, indicate that, in substance, the lender is an owner who controls the property. The borrower is treated as a minority partner or a manager. Loan to appraised value ratios over 80% (using SFAS No. 66 down payment requirements as the analogy to indicate "significant equity") and participation in management or in operations and/or residual of 50% or more are indicators of ownership or joint venture arrangements rather than loans.

Additionally, the accounting for convertible debt provides an analogy to participating mortgages. Convertible debt securities are those debt securities that are convertible into common stock of the issuer or an affiliated enterprise at a specified price at the option of the holder and that are sold at a price or have a value at issuance not significantly in excess of the face amount. The terms of such securities generally include (a) an interest rate that is lower than the issuer could establish for nonconvertible debt, (b) an initial conversion price that is greater than the market value of the common stock at time of issuance, and (c) a conversion price that does not decrease except pursuant to antidilution provisions. No portion of the proceeds from the issuance of convertible debt securities is accounted for as attributable to the conversion feature. The holder has the option to settle these instruments in cash just as in a participating mortgage and no charge to expense occurs unless the settlement terms change to encourage conversion.

We also believe the economics of participating mortgage transactions are, in concept, similar to hedging transactions, although we understand that participating mortgages have a non-monetary asset hedging a financial obligation. As noted previously under the proposed accounting, when the property appreciates in value, the income from operations gets worse, and when property depreciates in value, the income from operations improves. The operating results are not reflective of the property's real economics. This is discussed in paragraph 29 of the SOP which indicates that certain AcSEC members felt the increase in the participation liability should be recorded as an asset and depreciated over the remaining useful life. Paragraph 29 also indicates that this approach results in increased depreciation expense and reduced earnings as the property appreciates because appreciation retained by the borrower is not reflected. However, the interest expense method proposed in the SOP produces the exact same operating results. We continue to believe that both sides of the transaction need to be accounted for to properly reflect the accounting for this type of transaction and that the debit should be to property.

A similar accounting treatment of recording an obligation and debiting property exists in a current FASB project. In the FASB Project on Nuclear Decommissioning, the proposed accounting requires that the present value of the estimated future costs to decommission power plants, adjusted for inflation, be recorded as a liability with an offsetting increase to the cost of the plant which is depreciated over the asset's useful life. Subsequent changes in the estimated total cost of decommissioning are recognized as an increase to the liability and the plant asset and depreciated prospectively. Our understanding of existing GAAP is that environmental contamination costs not meeting certain requirements for capitalization described in EITF Issues 89-13 and 90-8 should be expensed. However, it appears the FASB has not linked the Decommissioning project with these existing requirements, instead making the argument that these costs exist at the inception of the project; the estimates of the ultimate cost will be refined as the end of economic useful life of the project approaches, and therefore, these are costs of the project at inception which should be depreciated prospectively as estimates change. While the decommissioning costs probably are not funded by participating loans, a similar fact pattern exists to participating mortgages, yet the proposed accounting provides for balance sheet treatment and depreciation on a prospective basis for decommissioning costs while participating mortgages are expensed through operations. We believe the accounting should be similar.

In addition to the fundamental issues described above, there is the issue of volatility of earnings as a result of the annual cumulative catch-up adjustment required under the SOP. The annual cumulative catch-up adjustment required by paragraph 32 of the SOP is based on analogy to paragraph 73 of SFAS No. 91 "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases. Paragraph 73 of SFAS No. 91 refers to homogeneous pools of loans with estimated prepayment patterns adjusted for changes in estimates. Changes in residual value estimates and their effect on the effective interest rate are more analogous to modifications of the interest rates of debt instruments which are accounted for prospectively under current GAAP. We believe this approach is preferable to the SOP methodology.

The Association is aware that AcSEC has considered several of the above arguments in arriving at the conclusions in the SOP. We strongly urge AcSEC to reconsider the accounting for the lender's residual participation. However, should AcSEC reach the conclusion that the proposed accounting is appropriate, we suggest that a more practical approach be considered. As noted previously, the methodology is exceedingly complex to understand and apply, administratively burdensome, misleading to users of financial statements and creates earnings volatility which is both unnecessary and irrelevant prior to a call, prepayment, refinancing or maturity of the debt instrument.

In SFAS No. 121, Accounting for the Impairment of Long-Lived Assets to be Disposed Of" (SFAS No. 121) and SFAS No. 107, "Disclosures About Fair Value of Financial Instruments" (SFAS No. 107), the FASB introduced some practical guidelines for determining if the recognition of impairment should be assessed and measured (paragraph 5 and 7 in SFAS No. 121) and whether it is practicable to estimate fair value of financial instruments (paragraphs 14 and 15 of SFAS No. 107). We believe this type of approach is warranted in the case of participating mortgages due to the significant changes in the market value of assets that generate the participating mortgage obligation which could occur over the term of the loan through maturity.

We suggest that disclosure of the estimated financial obligations be required in lieu of the actual recording of transactions in the books and records. Otherwise, to simplify the application of the SOP, we would propose the following:

- The effect of initially applying this proposed SOP should be to record a participating mortgage obligation and debt discount which would approximate the best estimate of the amount due at maturity.

- The debt discount would be amortized at the effective interest rate as if the obligation were paid at maturity.

- The effect of initially applying this proposed SOP should be reported in a manner similar to that of a cumulative effect of a change in accounting principle by utilizing a cumulative catch-up adjustment in the year of adoption to adjust the debt discount to the appropriate amount had the effective rate been know at inception.

- For participating mortgage financing arrangements entered into subsequent to the initial adoption of this proposed SOP, the participating mortgage obligation and debt discount should be calculated as noted above and the debt discount amortized prospectively using the effective interest rate.

- Any changes in residual value subsequent to the initial recording of the participating mortgage obligation should adjust the participating mortgage liability and debt discount. The debt discount should be amortized prospectively using the interest method consistent with the accounting for a modification of debt terms.

- The measurement of the participating mortgage obligation and the debt discount would be re-evaluated or adjusted based on events and circumstances which indicate it is probable that the ultimate obligation has changed similar to the process outlined in SFAS No. 121 for determining whether impairment of assets should be evaluated.

- Upon call, prepayment, refinancing or maturity, the difference between the carrying amount of the debt instrument and the actual amount paid should be treated as an extraordinary loss on extinguishment of debt.

Certified Public Accountants
and Consultants

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October 5, 1995

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Dear Mr. Stuart:

We are pleased to respond to the request for comments on AcSec's Exposure Draft of the proposed Statement of Position, Accounting by Participating Mortgage Borrowers (the "SOP"), because many of our clients have obtained debt financing in the form of participating mortgages. The SOP addresses the accounting by the borrower for the lender's participation in operations and in increases in market value of the mortgaged property.

We support the proposed current recognition of the lender's participation in operations. However, we are opposed to the issuance of the SOP in its current form regarding the proposed accounting for the lender's participation in market value increases of the mortgaged real estate project. We specifically disagree with recording the participation liability as a charge to current period interest expense. The SOP's proposed accounting produces the counter-intuitive result that a favorable event (the increase in market value of the real estate) yields a reduction in the current operating results of the property. For example, a property may have an increase in market value due to a change in economic circumstances of its competition. Despite an improvement in proposed revenues, current results are adversely affected due to increased interest charges under this SOP. These increased interest costs are generally only paid if the projected increase in market value actually is realized. In essence, the appreciation in the market value of the mortgaged property is a perfect hedge to the increased interest costs payable to the lender. Accordingly, we believe that the charge relating to the liability to the lender for the increase in market value should be recorded as an increase to the carrying value of the property rather than as increased interest expense.

The estimates that yield the projected lender participation liability are only probable to occur. However, because the asset and liability are inextricably linked, each being dependent upon the estimated increase in fair value of real estate, we believe that asset recognition to the extent of the amount of the lender participation liability is appropriate. We also believe that recognizing a probable asset in this situation is consistent with the standard for asset recognition set in EITF Consensus 93-5 and the proposed SOP on Environmental Remediation Liabilities. In addition, such asset recognition is analogous to the liability and related asset treatment of estimated future costs to decommission nuclear power plants as proposed recently by the Financial Accounting Standards Board. Further, because the lender participation is not 100% of the appreciation projected, any appreciation recorded as an asset would certainly be supportable under the impairment standards established by FASB Statement of Financial Accounting Standards No. 121.

Should AcSec decide that the proposed treatment of the charge related to the market value participation liability should be recorded as interest expense, we believe that the proposed accounting methodology is needlessly complex. The proposed accounting ignores the participation feature of the loan at inception, despite the fact that the participation feature is normally granted to the lender in exchange for a lower interest rate on the loan. The borrower normally has an estimate of the actual cost of such a feature at inception of the loan. The accounting should reflect this economic reality by having the borrower record, at inception, the debit discount related to the then market value participation payable to the lender. Changes to that initial estimate should only be made if events and circumstances indicate that the estimates should be revised. Finally, rather than recalculating retroactively the effective interest rate every year the participation liability is recalculated, we believe the effect on the debt discount of a change in the participation liability should be amortized prospectively. Prospective treatment is preferable as the change in the estimates of the participation liability is more similar to a modification in the interest rate of a loan, which is adjusted prospectively under current literature, than to nonrefundable fees and costs associated with originating loans as discussed in paragraph 32 of the SOP.

Richard Stuart
Page Three

October 5, 1995

We appreciate the opportunity to respond on this important issue. We should be happy to discuss our response with you at your convenience.

Very truly yours,

Morris Oldham, Partner

ROBERT F. RICHTER, CPA
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AUTHOR: SEC ACCOUNTING AND REPORTING MANUAL

October 5, 1995

Richard Stuart, Technical Manager
Accounting Standards Division
American Institute of CPAs
1211 Avenue of the Americas
New York, N.Y. 10036-8775

Re: File 4210.PM - Accounting by
<u>Participating Mortgage Loan Borrowers</u>

Dear Mr. Stuart:

I disagree with the accounting for participating mortgages as proposed in the exposure draft dated July 5, 1995. That accounting does not reflect the fact that a transfer to a lender of a right to participate in appreciation in the value or operations of real estate reduces the borrower's economic interest in the property.

The value of the right should be estimated as of the date of transfer. It should be recorded as a deferred debt cost and amortized using the interest method over the life of the loan. The carrying amount of the property should be reduced to reflect the reduction in the borrower's economic interest in the property. The amount of the reduction should be based on the relative fair values of the portion transferred to the lender and the portion retained (which should sum to 100 percent of the value of the property). A gain or loss should be recognized for any difference between the value of the interest transferred and the allocated cost of that interest. Depreciation of the property should be based on the reduced property carrying amount.

In future periods, the lender's ownership interest in the operations of the property should be reflected in the borrower's income statement as a reduction in the net income to the borrower, but not as interest expense. The reduction is an undivided interest in the operations, like a minority interest.

Because appreciation in the value of the property is not recognized in the balance sheet, no participation liability should be accrued as the value appreciates. However, if and when a liability to pay the appreciation occurs, a corresponding asset should be created. That asset represents the borrower's right to realize the appreciation for which payment has been or will be made to the lender. If and when the appreciation is realized, the borrower will recover the asset. To the extent that the appreciation is not likely to be realized because the property will be held for a long period of time, the asset should be depreciated.

Paragraph 28 of the exposure draft indicates that a method involving valuation of the right was rejected "due to concerns" about the ability to determine that value. There will always be such concerns, but that should not lead to accounting that distorts the economic facts. The value of the participation right is a portion of the value of the property. Techniques used to estimate the property value, particularly discounted cash flow, can also be used to estimate the value of the right.

From a practical standpoint, valuation of the right is preferable because it is done once. The exposure draft, however, would require property appraisals at each balance sheet date.

I have some additional concerns with the accounting proposed in the exposure draft. First, as and if the property appreciates, income would be reduced. This simply distorts the truth and renders accounting less useful. Second, the exposure draft does not seem to recognize the fact that the carrying amount of the property could be impaired as a result of the transfer of the right to the lender. These issues do not arise with the accounting recommended above.

I urge that AcSEC reconsider the proposed accounting. This accounting issue has been around for a long time, and was actively debated by the Real Estate Committee in the 1980s. Unfortunately, a majority view never occurred. As a participant in those deliberations, I have had the benefit of much thinking and discussion on the issue.

Thank you for considering my comments. If you have any question, please call me.

Sincerely,

Robert F. Richter

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nysscpa

October 17, 1995

Richard Stuart, Technical Manager
Accounting Standards Division
File 4210.PM
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Re: **Proposed Statement of Position-Accounting by Participating Mortgage Loan Borrowers**

Dear Sir:

The New York State Society of Certified Public Accountants is pleased to submit its comments on the above exposure draft. The comments were developed by the Financial Accounting Standards Committee.

While not objecting to the issuance of this SOP, the Committee is concerned about the use of a mixed attribute system whereby a liability is based on fair market value while the asset on which such liability is determined remains at cost.

The summary to the draft indicates that "At the end of each reporting period, a participating liability...." The draft does not define reporting period and the question arises as to its applicability to interim statements. If the intent is to have it apply to interim statements, must a preparer make a new estimate of fair market value each time interim statements are issued?

The first sentence of paragraph 13 appears to offer an option to the preparer of the financial statement. The liability would be based on either an assumption the property is sold or the mortgage loan matured or was refinanced. Another interpretation would be that the computation should be based on either one depending on the terms of the participation as described in paragraph 5. The wording of this sentence should be changed to reflect AcSEC's intent.

The number appearing on page 16 as $479,205 should be $470,205.

If you have any questions regarding these comments, please let us know and we will arrange for someone from the Committee to contact you.

Very truly yours,

William M Stocker, III

William M Stocker, III, CPA
Chairman, Financial Accounting Standards Committee

Walter Primoff

Walter M. Primoff, CPA
Director, Professional Programs

cc: Accounting and Auditing Committee Chairs

ILLINOIS CPA SOCIETY & FOUNDATION

October 12, 1995

Mr. Richard Stuart
Technical Manager
Accounting Standards Division
File 4210.PM
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Stuart:

The Accounting Principles Committee of the Illinois CPA Society ("Committee"), is pleased to have the opportunity to comment on the Exposure Draft of the Proposed Statement of Position, "Accounting by Participating Mortgage Loan Borrowers" ("Proposed Statement"). The organization and operating procedures of the Committee are reflected in the Appendix of this letter. These recommendations and comments represent the position of the Illinois CPA Society rather than any of the members of the Committee and of the organization with which they are associated.

The Proposed Statement primarily deals with the borrower's accounting for mortgage loans when the lender participates in the increases in the market value of the mortgaged real estate project. Since most of these projects were initiated in the 1980's and have since significantly diminished, the Committee questions the need to issue this Statement since it has limited current application.

The Committee did not agree with the accounting treatment as recommended in the Proposed Statement. The primary objection was the charging of interest expense in the current period for the new effective interest rate being applied retroactively, resulting in a cumulative adjustment.

As an alternative, the committee recommends two majority views which are as follows:

1) Initially estimate the value of the participating mortgage loan arrangement and use an effective interest rate based on the value of the participating mortgage loan arrangement. The lending institution could indicate the value by proposing two rates to the borrower, with and without the participating mortgage loan arrangement. The liability would be adjusted annually for any mortgage loan increases and the increases would be amortized over the remaining period of the loan.

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2) Record the loan and interest as suggested in the Proposed Statement except that the prior years' cumulative effect would be amortized over the remaining years of the loan. This would eliminate the cumulative adjustment when the rate changes.

In addition, the Committee has two concerns regarding the implementation of the Proposed Statement, which are stated below:

(1) The cost of the annual appraisal
(2) The reliability of the appraisal.

Cost of Annual Appraisal

The limited number of members having had experience with the participation loans indicated the loan documents generally do not require an annual appraisal. Therefore, the annual appraisal would be an additional cost to the borrower.

Reliability of Appraisal

The Committee voiced some concern as to the reliability of real estate appraisals and their effect on the financial statements. It has been the experience of the Committee that independent appraisals can vary significantly.

We would be pleased to discuss our comments and recommendations with you or the members of the Accounting Standard Division.

Very truly yours,

Joan E. Waggoner

Joan E. Waggoner
Chair

APPENDIX A

ILLINOIS CPA SOCIETY
ACCOUNTING PRINCIPLES COMMITTEE
ORGANIZATION AND OPERATING PROCEDURES

1995 - 1996

The Accounting Principles Committee of the Illinois CPA Society (the Committee) is composed of 29 technically qualified, experienced members appointed from industry, education and public accounting. These members have Committee service ranging from newly appointed to 15 years. The Committee is a senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of accounting principles.

The Committee usually operates by assigning a subcommittee of its members to study and discuss fully exposure documents proposing additions to or revisions of accounting principles. The subcommittee ordinarily develops a proposed response which is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times, includes a minority viewpoint.

MASSACHUSETTS SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS, Inc.
105 Chauncy Street, Boston, MA 02111 (617) 556-4000 FAX (617) 556-4126 Toll Free 1-800-392-6145

November 7, 1995

Richard Stuart, Technical Manager
Accounting Standards Division, File 4210.PM
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

RE: Exposure Draft (ED) Proposed Statement of Position "Accounting By Participating Mortgage Loan Borrowers"

Dear Mr. Stuart:

The Accounting Principles and Auditing Procedures Committee (Committee) is the senior technical body of the Massachusetts Society of CPAs. The Committee consists of over 30 members who are affiliated with accounting firms of various sizes, industry and academia. The Committee has reviewed and discussed the Exposure Draft (ED) Proposed Statement of Position "Accounting By Participating Mortgage Loan Borrowers" and is in substantial agreement with the general guidelines expressed in it, and has no further comments. The view is solely that of the Committee and does not reflect the view of the organizations with which the Committee members are affiliated.

The Committee appreciates the opportunity to participate in the Accounting Standards Division due process procedures and to have our views considered by the Division.

Very truly yours,

Thomas J. Vocatura

Thomas J. Vocatura, Chairman
Accounting Principles and Auditing Procedures Committee
Massachusetts Society of CPA's